European Financial Markets Lawyers Group

- THE VICE CHAIRMAN -

CONFIDENTIAL

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Via regular mail and
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Dear Sirs,

EUROPEAN REGULATORY FRAMEWORK FOR FINANCIAL MARKETS

As you may know, the European Financial Markets Lawyers Group is a group of senior legal experts from the EU banking sector dedicated to making analysis and undertaking initiatives intended to foster the harmonisation of laws and market practices and facilitate the integration of financial markets in Europe[1].

The last ten years have been a period of intensive rulemaking in Europe. In particular, the European Union has taken essential steps to restore financial stability and public confidence in the financial system, as well as increasing investor protection and enhancing transparency in financial markets.

While we view the measures that have been adopted as an improvement in many areas and we recognize that they were necessary in order to enhance investors' protection and market integrity, we are also of the opinion that their combined impact should be carefully assessed in order to identify any unintended consequences and eventually adopt the necessary actions to mitigate them. Indeed, the European Commission itself is finalizing the exercise it launched along these lines with the Call for Evidence: EU regulatory framework for financial services on 30 September 2015.

In this context, this letter deals with certain aspects of the rulemaking process in Europe which are of concern and on which we kindly request the authorities to adopt measures to foster good rule-making, to preserve legal certainty, to avoid inconsistencies within the European regulatory framework and to protect the single market at EU level; what seems to be in line with the goal of the Capital Markets Union (CMU) initiative.

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[1] More information about the EFMLG and its activities is available on its website at www.efmlg.org.

We have identified hereafter some issues that are either incorporated in a legislative measure in force or are now being discussed. The examples below are illustrative cases of such issues where improvement is clearly warranted.

While the first set of items (see Section A) should be addressed in the immediate term, id est. during the current discussion and / or before the relevant measures are adopted. Our understanding is that the second group of concerns (see Section B) should be considered in the medium term.

A) Matters of concern that should be addressed in the immediate term.

1. Lack of coordination among regulations: overlaps, duplications and inconsistencies. European legislation on financial markets has been passed at different stages over the last years, and, therefore, any legal act/measure was assessed on an individual basis. The problem arises when these rules are considered together, as they may give rise to duplications, inconsistencies, regulatory gaps and/or lack of proper enforcement at national level. Some examples can be found in the following legal acts:

- **PRIIPs Regulation[2] vs. MiFID 2[3]:** Both PRIIPs and MiFID 2 contain pre-contractual disclosure requirements when dealing with retail clients, specifically regarding risks and costs. Although these legal acts do not cover exactly the same scope of products, there will be a broad range of products that will be subject to both set of rules. In this context, investment firms should be able to rely on the PRIIPs Regulation to comply with the MiFID requirements. For the sake of legal certainty, it would be helpful to include in the PRIIPs Regulation or in the MiFID a specific reference to the fact that the Key Information Document (the "KID") satisfies MiFID pre-trade transparency obligations of the product manufacturer, so as to avoid unnecessary duplication of documentation[4]. In our view, the duplication of these disclosure requirements is detrimental both for investment firms (due to the consequent increased operational burden and administrative costs) and for clients (where excessive and duplicative documentation could detract from the effectiveness of such communications and lead clients to lose sight of what is important). An effort should be made to align the information requirements within both legal acts, as much as possible, to avoid documentation overload of clients.

- **PRIIPs Regulation vs. Prospectus Directive[5]:** whilst the Prospectus Directive is not applicable to all products falling under the scope of PRIIPs, it will be applicable to a significant range of such products. We note that delineation of the purpose of the two legal acts would reinforce the purpose of the KID

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2 Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs) OJ L 352, 9.12.2014, p. 1–23

3 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU OJ L 173, 12.6.2014, p. 349–496.

4 Article 51 of the proposal for Delegated Regulation for MiFID dated 25.04.2016 states that if there are any costs or charges not included in the KID, investment firms should inform clients about them, but there is no clear statement specifying, for instance, that "When investment firms comply with the obligation to provide the KID in good time to the client, they are complying with MiFID pre-trade information requirements related to costs and risks" (http://ec.europa.eu/finance/securities/docs/isd/mifid/160425-delegated-regulation_en.pdf).

5 Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, OJ L 345, 31.12.2003, p. 64–89.

as a tool for investors to compare PRIIPS and satisfy MiFID pre-trade transparency obligations, but not as a tool based on which investors should make investment decisions, especially in case a prospectus has been issued. As such, where appropriate, it would be helpful for investors to be directed to the relevant Prospectus Directive documentation from the KID.

We also note that different approaches are taken with respect to the disclosure risks under the PRIIPs Regulation and the Prospectus Directive – we are concerned that the information that is required in the KID is not required under the Prospectus Directive and vice versa. Further, a formal guidance in this regard and also with respect to any other area of overlap would increase confidence in the market. In addition, we note that where products are being offered subject to the disclosure requirements of the Prospectus Directive or in relation to product issuers that are subject to continuing obligations (e.g. under product issuance programs), any 'significant' change is required to be notified to the market. It is not clear to what extent such a rule is in line with the requirement under PRIIPs Regulation to review and republish a KID. In order to increase the efficiency of the market, the ability to review or supplement a single document for the purpose of satisfying disclosure requirements under both regimes should be considered, to the extent possible.

- **Overlap among EMIR[6], MiFID 2, MiFIR[7] and SFT[8] regarding reporting requirements**: Reporting obligations have been implemented by a number of EU legislative acts towards different regulatory bodies, which result in firms[9] reporting the same information more than once. Greater co-ordination between legislative initiatives is required to avoid firms incurring unnecessary costs and resources to comply with repeated obligations. Art 71 of the BRRD[10] implements obligations to create and maintain a register with information very similar to what required by EMIR, MiFID 2/MiFIR and SFT. Such duplicative obligations result in onerous and unnecessary burden on banks hindering their essential role as catalysts of the CMU. Thus, reporting obligations under EU legislation should be harmonised (in particular, regarding data to be reported, technology to be used, ways of completing relevant data, requiring and allowing counterparties to develop the best way to report directly to the national competent authorities or using the services of a third party), and, in certain cases, it could be centralized in a single central repository which would manage and consolidate the data requirements of firms.

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6 Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, OJ L 201, 27.7.2012, p. 1–59.

7 Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012, OJ L 173, 12.6.2014, p. 84–148.

8 Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012, OJ L 337, 23.12.2015, p. 1–34.

9 Entities in scope differ among the different regulations.

10 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, OJ L 173, 12.6.2014, p. 190–348.

2. Late approval of rules. Lack of coordination and dispersion among different rules

2.1 Lack of coordination on the rulemaking process in the EU. Formal aspects of the rulemaking process may also have unintended consequences for the financial market. In particular, the delay in the adoption of certain rules and the lack of coordination when preparing and consulting on these measures entail a rather complex framework for market participants and may result in tight implementation deadlines for a number of important rules. Some examples can be found in the following regulatory initiatives:

- The **PRIIPs Regulation** will enter into force in January 2017; however, the final Level 2 rules have not been approved yet. This has given rise to a great legal uncertainty for market participants who stand ready to implement any necessary measures to comply with the regulation on a timely manner. However, due to the level of complexity and the detail of technicalities that those Level 2 rules introduce, various clarifications would be required (i.e. the industry has already raised a number of concerns in respect of several sections of the draft technical advice published by the European Supervisory Authorities – the ESAs), and any minor change that may be incorporated in the final regulatory technical standards may have considerable implications for investment firms in terms of costs and time. This may lead to a situation where firms will probably not be able to adapt to the relevant legal requirements during the first months.

  In addition, as an example of the lack of coordination among different regulatory initiatives, we question whether it is appropriate that the PRIIPs Regulation enters into force before MiFID 2, when there is a clear interdependency between both legal acts. In particular, **(a)** the product governance obligations established in MiFID 2 seem to be a prerequisite for the creation of the KID (i.e. the identification of a target market is a requirement specified in MiFID 2, although it is one of the sections that must be covered by the KID); and **(b)** there is an overlap on disclosure requirements (specially concerning risks and costs). The PRIIPs Regulation itself mentions the fact that "*This regulation is complementary to measures on Distribution in Directive 2014/65/EU of the European Parliament and of the Council*". Thus, in our opinion, an alignment of MiFID 2 and the PRIIPs Regulation should be pursued, including the review of the implementation deadlines.

- The **Benchmark Regulation**[11] was adopted by the European Parliament on 28 April 2016 and was published in the Official Journal in June. However, even before the final text was approved (including certain amendments in respect of the last text agreed during the trialogue meetings that took place in December 2015), a Discussion Paper regarding the technical implementation of the incoming regulation has been published on 15 February 2016. In this respect, we question the appropriateness and effectiveness of consulting on the Level 2 rules at the time when the Level 1 rule has not been definitely adopted, and may be subject to further amendments. In addition, we also note that a new

[11] Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014, OJ L 171, 29.6.2016, p. 1–65.

consultation paper on draft technical advice under the Benchmark Regulation was published on 27 May 2016.

Our proposal to address such kind of inconsistencies is to link the implementation deadline of a Level 1 regulation to the date of adoption of the Level 2 rules. For instance, the Level 1 rule could specify that the entry into force of the relevant regulation will be the latter of the following two dates: (a) a specific date [X] that expectedly allows sufficient time for any further regulatory developments and adaptation of market participants; or (b) [X] months after the publication of the relevant regulatory technical standards.

In addition, we point out that it is of utmost importance that the ESAs are provided with a sufficient time in order to produce Level 2 rules. These rules can be extremely complex and have a great impact on the market; therefore, they require careful consideration and reflection. In some cases, the deadlines imposed on the ESAs are too tight and not realistic. More time should be granted so that any unintended consequences are properly calibrated in advance.

2.2 Potential infringement of Level 1 by Level 2 rules. The development of regulatory technical standards is deemed essential for the purpose of clarifying and developing certain obligations/requirements contained in Level 1 rules. However, we are concerned that, in certain cases, these regulatory technical standards contravene the Level 1 rules, or go beyond their mandate or intended content. Some examples of the aforementioned situation are the following:

- **Product Governance:** Article 16.3 of MiFID 2 stipulates that manufacturers of a financial instrument are obliged to establish a product approval process which includes the identification of a target market of end clients. In addition, the "*investment firm which manufactures financial instruments shall make available to any distributor all appropriate information on the financial instrument and the product approval process, including the identified target market of the financial instrument*". While Level 1 seems to be clear that it is the manufacturer of the financial instrument who should determine the target market, the last draft of the Commission Delegated Directive supplementing MiFID 2[12] requires that distributors "*shall use the information obtained from manufacturers and information on their own clients to identify the target market and distribution strategy*". This Level 2 rule appears to extend the obligation to determine the target market to distributors.

- **Recordkeeping requirements:** Article 16.7 of MiFID 2 states that "*Orders may be placed by clients through other channels, however such communications must be made in a durable medium such as mails, faxes, emails or documentation of client orders made at meetings. In particular, the content of relevant face-to-face conversations with a client* ***may be recorded*** *by using written minutes or notes. Such orders shall be considered equivalent to orders received by telephone*". In short, the Level 1 rules recognize the possibility (but not the obligation): **(i)** to receive client orders at meetings; and **(ii)** to produce written minutes to document meetings with clients whenever such meetings result in the placement of an order.

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[12] http://ec.europa.eu/finance/securities/docs/isd/mifid/160407-delegated-directive_en.pdf

However, the last draft of the Commission Delegated Regulation supplementing MiFID 2 as regards organizational requirements and operating conditions for investment firms goes well beyond Level 1 by establishing the obligation (rather than the possibility) to document all relevant meetings with clients. In particular, the proposed Level 2 rules state that "*Investment firms **shall** record in a durable medium all relevant information related to relevant face-to-face conversations with clients*". Therefore, there is no legal empowerment to impose the aforementioned obligation and the delegated acts should be consistent with the Level 1 rules. Accordingly, the Commission's delegated acts should foresee the possibility to document meetings with clients when these result in the placement of an order, but should not specify this as an obligation. Furthermore, as per Article 16.7 of MiFID 2, the recording of written minutes documenting meetings with clients only applies whenever such meetings result in the placement of an order. In view of paragraph 17 of ESMA's Final Report on its Technical Advice to the Commission on MiFID II and MiFIR[13] we understand that this is the rationale behind the draft Level 2 rules; however, as the last version of the Level 2 rules refers to "**relevant** face-to-face conversations" and uses the plural form when specifying the information to be recorded during such conversations (date and time of **meetings**, location of **meetings**, etc.), one may conclude that the recording of written minutes applies to almost any meeting with clients where a potential transaction (whether it is finally concluded or not) is discussed. This would contravene the Level 1 rules. Thus, clarification would be required with respect to the minimum criteria applicable to records and how to document meetings.

2.3 Special reference to Level 3 rules. In addition to the series of legislative initiatives at European level, the publication of Q&A documents, statements and guidelines issued by European authorities for the purpose of interpreting or clarifying certain aspects of Level 1 and Level 2 rules is becoming a more frequent practice. Whilst we may share the European Commission's view with respect to the appropriateness and value of such documents, we point out our concern with respect to **the timing** of the preparation of these documents in the recent past. In particular, some of these documents are discussed and even published before the Level 2 rules of the relevant Level 1 legislation have been adopted.

For instance, the industry is aware that a document in the form of a guideline or Q&A is being prepared regarding MiFID 2 and the PRIIPs Regulation. In fact, a draft has been distributed to some (but not all) market participants and associations. In our opinion, any necessary clarification or further development identified before the adoption of the Level 2 rules should be accurately included in those Level 2 rules. This would promote legal certainty, homogeneous application of the rules throughout the European Union and the proper control of the content of those documents by the European Commission, the Parliament and the Council. The drafting of Level 3 measures while the Level 2 rules have not been yet adopted is difficult to understand from a legislative perspective and should not be considered as a tool to clarify and provide a homogeneous interpretation of the (future) legislation. Whilst Level 2 is still to be adopted, the unique tool to promote clarity and certainty should be such Level 2 legislation.

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[13] https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf

It should also be noted that Member States may decide not to comply with certain guidelines (i.e. UK, France and Germany notified that they would not comply with the guidelines issued by ESMA on the market making exemption for the purposes of the SSR[14]), which prevents an homogeneous application of the EU framework among Member States and creates an un-level playing field.

In addition, in relation to **the content** of Q&A documents or guidelines issued by European authorities, we are concerned that these documents may go beyond their initial purpose (i.e. to clarify or interpret certain concepts or provisions). For instance, the Q&A document that is being discussed in relation to MiFID 2 substantially appears to develop the target market provisions. Another example is the recent statement published by ESMA on MiFID practices for firms selling financial instruments subject to BRRD resolution regime[15]. The said document imposes new disclosure requirements on investment firms by requiring informing clients about the consequences that the adoption of resolution measures may entail. In this respect, we question (i) whether it is really necessary to add more information requirements when in fact the BRRD has improved the situation of clients in the event of insolvency of firms ("no worse than bankruptcy"); (ii) whether this information should be included in the KID (bearing in mind the limitation of space in such document); (iii) the value or enforceability of such statements; and (iv) the opportunity to publish these new disclosure requirements by way of an "ESMA statement" when the Level 2 rules specifying the information that firms shall provide to clients under MiFID 2 are still under discussion.

We understand that such documents should have a limited scope so that they do not create, impose or anticipate[16] new figures or additional obligations, but merely clarify or interpret certain concepts or provisions; particularly taking into account that: (a) Q&A documents, statements or opinions are not expressly recognized under Article 16 of Regulation 1095/2010 of 24 November 2010 establishing a European Supervisory Authority; and, thus, (b) these kind of documents are not subject to public consultation or to the control of European institutions.

A possible way to address this issue would be **(i)** if Level 2 Regulation is under discussion, no Q&A documents should be prepared as the appropriate place to include any clarifications regarding Level 1 should be included in the Level 2 rules; **(ii)** if Level 2 Rules are already in place, to limit the scope of a Q&A to what they should really be, i.e. a way to help the market solving their interpretative questions; and, in any case, (iii) documents such as Q&A documents/statements/opinions should expressly state that they do not have binding force (in accordance with Article 288 of the Treaty on the Functioning of the European Union).

3. **Uncoordinated local rules.** Member States have adopted different approaches when determining whether a foreign exchange (FX) contract falls under the definition of "financial instrument". In particular, there are inconsistencies with regards to the delineation between FX spot and FX forward transactions. This different interpretation among Member States has led to an inconsistent application of MiFID, EMIR

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[14] Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps

[15] https://www.esma.europa.eu/sites/default/files/library/2016-902_statement_brrd.pdf

[16] For instance, the Opinion on MiFID Practices for firms selling complex products and the Opinion on structured retail products published by ESMA on 7 February and 27 March 2014, respectively, anticipate some of the requirements set forth in MiFID 2 although these will enter into force, expectedly, in January 2018.

and potentially other EU legislation that rely on the MiFID definition of "financial instrument". Furthermore, the question arises not only regarding the boundary between FX spot and FX forward transactions, but also in respect of the possibility to exclude certain FX forwards on the basis of their purpose. In particular, some Member States have considered that FX forwards concluded for commercial purposes are not financial instruments. The lack of clear definitions has led to market uncertainty with regard to regulatory requirements, and rules are being applied on an inconsistent basis. Although the Commission has tried to address this issue in the context of MiFID 2 (Article 10 of the last draft of the Commission Delegated Regulation supplementing MiFID 2 specifies the relevant criteria to determine when a contract relating to a currency shall not be considered a financial instrument), the current wording still gives rise to a great uncertainty. We urge the Commission to clarify the definition of financial instrument in this respect so that a harmonized European definition is adopted across the EU and a level playing field is preserved.

B) <u>Matters of concern that should be addressed in the medium term.</u>

1. Lack of coordination among legislative measures: definitions. Different European legislative measures in relation to the financial markets contain similar definitions; however in some cases: **(a)** those definitions differ from one legal act to the other (e.g. the concept of market maker or market making activities differs from MiFID 2 to SSR, the definition of liquid market or liquid instrument under MiFID 2/MiFIR for the purpose of transparency requirements is not in line with the concept of "illiquid instrument" contained in the Consultation Paper[17] on PRIIPs for the purpose of including certain warnings in the KID, etc.); or **(b)** have been interpreted differently among Member States, giving rise to a number of inconsistencies.

2. Uncoordinated local rules. Differences in national legislation in the investor protection area (and, more specifically, on pre-trade information) create an un-level playing field among Member States, erecting additional barriers to a single market in financial services and products. However, it seems that many Member States, in order to protect their national retail investors, have been adopting, during these intervening years, a host of new laws and regulations and publishing policy papers and guidance. Thus, the current situation of retail investor protection rules in the EU, when dealing in financial instruments, is characterised by considerable and increasing disparity of national legislation in each Member State which gives rise to legal uncertainty, and results in an increasingly disrupted EU single market. Some examples of these national regulations are as follows:

- Legislation requiring investment firms to provide its retail clients and potential retail clients with a risk indicator of each particular product has been introduced in some Member States in these last years (i.e., just to mention several cases, in Denmark, the "Executive Order on Risk-Labelling of Investment Products", breaking down the types of investment product into three labeling categories: green, yellow and red; in Netherlands, the 'Nadere regeling gedragstoezicht financiële ondernemingen Wft'[18],

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17 https://www.eba.europa.eu/documents/10180/1268855/JC+2015+073+CP+PRIIPs+Key+Information+Documents.pdf

18 See http://wetten.overheid.nl/BWBR0020540/geldigheidsdatum_10-04-2015 (in Dutch).

requiring the provision of a risk indicator divided in five categories graphically presented as a stick man that carries more weight as the risk increases; in Spain, the "Orden ECC/2316/2015, de 4 de noviembre, relativa a las obligaciones de información y clasificación de productos financieros[19]", requiring firms to provide among other information in the form of padlocks and exclamation marks, with a risk indicator with six labeling categories, etc.).

- In Spain, since August 12, 2013[20] retail clients must provide handwritten statements when purchasing any financial instrument when the result of the appropriateness assessment is negative, or when, due to a lack of information, such assessment has not been made (e.g.: "this is a complex product and it is considered not appropriate for me").

4. CONCLUSIONS

The European regulatory framework has drastically changed during the past years. Many of the adopted regulatory measures, considering them individually, were necessary and appropriate for the purpose they pursued. However, with the majority of the regulatory reform having been adopted, there are growing concerns about the interaction between the various legislative reforms, their cumulative impact on the financial markets and the timing of their implementation.

In view of the considerations put forward in this letter, we kindly request the authorities to consider and adopt measures to foster good rule-making and to protect legal certainty and the EU single market. In order to be proactive, we suggest the below action points, for consideration:

(i) reviewing the coordination and interaction of existing and future legislation to avoid any inconsistencies among the different rules;

(ii) providing enough time to market participants to adapt to new legislation, as well as linking the application date of the Level 1 rules to the publication date of the related Level 2 measures that are necessary for the understanding and implementation of the different obligations under the Level 1 rules;

(iii) ensuring the adequate coordination between the requirements laid down at Level 1 and Level 2, avoiding any potential contradiction within Level 1 by way of lower-ranking norms;

(iv) working with the ESAs to ensure that no Level 3 measures are prepared or published until the Level 2 rules has been published and the need for interpretation has been raised;

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[19] See https://www.boe.es/boe/dias/2015/11/05/pdfs/BOE-A-2015-11932.pdf
[20] See https://www.boe.es/boe/dias/2013/06/19/pdfs/BOE-A-2013-6658.pdf

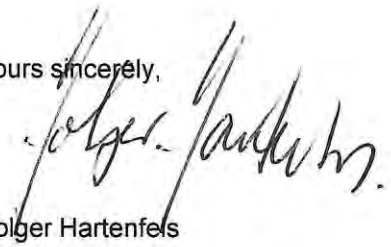
(v) limiting the content of Level 3 measures to such questions that provide clarity to the market and promote the homogeneous interpretation and application of the law, without creating new obligations or figures or contradicting to the Level 1 or Level 2 measures; and

(vi) promoting the homogeneous application of European laws and removing any national legislation that may hamper the goal of European directives or regulations.

In addition to these general rulemaking proposals, for some of the issues specified in this letter in case of which there is still time to reconsider whether the envisaged approach is the most appropriate one, we urge the relevant authorities to carefully analyze our suggestions in order to adopt appropriate measures in a timely manner, before additional unintended consequences may arise.

We remain at your full disposal for any support we may provide from the EFMLG on the points covered in this letter.

Yours sincerely,



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